
The Idle Speculator™

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The Ascendance (and Continuing Ignorance) of Risk

It seems natural that after any system has experienced significant carnage, or at least a meaningful threat of it, ideas about risk and how to manage it come to the fore. That's certainly been the case over the last couple of years, and it's snowballed in the wake of Lehman's failure and AIG's near failure¹. This week, we're seeing these ideas take a prominent role in two major policy areas - health care reform and financial services regulation.

Assigned Risk Comes to Health Care?

In health care, one of the Obama administration's primary objectives is to create a "public option" that would compete with the plans of private insurers. However, concerns have been expressed in different quarters over the public costs of such a plan, and the effect it would have on private insurers and health care providers. An initial compromise proposed in the Senate Finance Committee was the possibility of a public [co-op](#) which would be run as a non-profit rather than a government service². However, a third proposal - nonstandard risk pooling - has been put forth by some in the insurance industry. This would institute a framework in which all insurers agree to take on a proportional share of risks that they otherwise would not underwrite. This is very similar to the nonstandard or "[assigned risk](#)" system for automobile insurance that now exists in many states, where a proportional number of undesirable insureds are assigned to each licensed auto insurer. This option sounds worthy of further study, but there are some important considerations to bear in mind.

First, in auto insurance, assigned risk premiums are largely borne by the higher risk³ insured, and the coverage is typically the minimum liability and medical coverage required by state law. Second, it's a very tough business to administer and to settle claims

- 1 Though we'd note that cutting edge financial planning has been moving in that direction for some time, catalyzed most recently by the 2000-2002 market meltdown. Some notable conceptual and technical progress has occurred in recent years, as academics and some practitioners have emphatically made risk management – for example, how much one can afford to lose, and how to protect what they can't afford - the primary objective in designing long term financial strategies.
- 2 We continue to make the point (perhaps too quietly?) that many of our current challenges of political economy are rooted in the federal tax code. Health insurance is definitely one of them. For example, the mandate for employers to provide health benefits, and the more favorable tax treatment that employer provided benefits receive, are bound to have a negative impact on individual buyers of health insurance. While we don't have an elegant mathematical model to describe the effect, I have some interesting anecdotal evidence, in the form of my self-employed mother-in-law's written tirades to elected representatives and newspaper editors over the past 40+ years!
- 3 We'd note that in some states, drivers are steered into the assigned risk pool who are not necessarily higher risks. This might be a potential problem in an assigned risk health insurance scheme.

in - companies that make money in it have to fight tooth and nail to hold on to every premium dollar they can - which doesn't make them very popular. Others tolerate it as a cost of doing business, which has a negative impact on insurers' returns on capital. Finally, assigned risk coverage is only mandatory for those nonstandard risks who want to own a car.

In a similar system for health insurance, it's not clear who would bear the additional cost of nonstandard risk. Would it be standard risk insureds via higher premiums? That's quite possible, but could be piled on top of health benefits losing their federal tax protection. Will it be insurance executives via lower compensation? Perhaps, but we wouldn't count on it. Will it be shareholders and/or mutual company members, via lower profits and/or dividends? Or taxpayers via public subsidy? Those last two seem most likely. However, the costs to existing insureds, private capital, and taxpayers are among the very problems posed by public health insurance! So it's not clear yet what a nonstandard system alone could accomplish, other than keeping public coverage confined to Medicaid and Medicare, and most importantly, to whom the benefits would accrue. Finally, what magnitude of investment would be required for health insurers to administer and manage these types of plans, especially given their much larger scale relative to auto insurance? There will be far more people to insure, and unlike auto insurance, none of them can 'surrender their tags' more than once, so to speak, under a mandatory system.

The “L Word” At Last

In financial regulation, we're seeing a bit more attention paid to the problem of excessive leverage, which helped precipitate the crisis by leaving the financial system in an especially [fragile](#) state, as we pointed out in the 'postmortem' section of our 2008 Outlook:

By 2007, the overall debt of U.S. households, governments, and corporations had reached levels that implied a high degree of systemic leverage, i.e., a high level of assets relative to equity or net worth (recall the basic accounting equation: assets = liabilities + equity). Leverage is tolerable as long as the liabilities can be serviced, e.g., through current and future income, such as salaries for a household, investment income for a bank, operating income for a corporation, and tax revenues for a government entity. But higher leverage leads to greater systemic fragility; there's a much smaller cushion available to absorb falling incomes due to unemployment, investment losses, declining sales, or lower tax revenues. That is essentially where the U.S. financial system stood in 2007, and the result was a series of spectacular crashes, as one financial domino fell after another.

Warren Buffet put his finger on the leverage issue in an [interview](#) with Bloomberg TV yesterday, saying it was a primary cause of the crisis (recall that he characterized leveraged derivatives as 'Weapons of Mass Destruction' several years ago), and quoting a friend's characterization of leverage as something that smart people don't need, and that dumb people shouldn't mess with.

The Wall Street Journal's “Ahead of the Tape” [column](#) also focused on it last week:

In 2006, at the height of the boom, a bank purchasing a triple-A mortgage security valued at \$100 needed to put up just \$1.60 in cash - the rest could be borrowed. Home buyers could get a mortgage with a 5% deposit, sometimes even less. Insurers such as American International Group sold bets known as derivatives to book fees for promises they ultimately couldn't keep, a hidden form of leverage.

As we've indicated previously, leverage at that level all but assures the eventual destruction of capital, and a lower net asset position for the system as a whole – which is where the present crisis has brought us.

We also came across a good, short [piece](#) by economist Woody Brock that he penned back in 2008 ("Five Delectable Examples of Stein's Law") before the crisis fully took hold in the 3rd quarter:

...almost no one singles out the distinctive role of excess leverage not only as the principal culprit, but perhaps the only variable than [sic] can and should be regulated by government—as it once was. Indeed, in his lengthy and much discussed March 17 Op-Ed piece in the Financial Times, former Fed Chairman Alan Greenspan never once cited the role of leverage in wreaking today's havoc. This oversight is as irresponsible as it was unbelievable, but it epitomizes the deficient analyses of consensus pundits.

Unfortunately, we see little evidence in the reform ideas being bandied about by regulators and policymakers that the leverage problem is fully understood. Talk of requiring securitizers to keep some skin in the game by holding at least 5% of newly packaged securities on their own books should have a *marginal* dampening effect. But regulating systemic leverage will take a much larger umbrella and some expansive oversight powers. On top of that, leverage has become an increasingly global problem⁴ in the last two decades, which makes its regulation that much more problematic.

Perhaps the inescapable complexity of credit system leverage is at work in the apparent unwillingness of policymakers and regulators to tackle it head on - which makes one wonder how much damage it will have to do before the global electorate finally demands better oversight. Buffett noted that complexity in an [interview](#) with CNBC yesterday:

BUFFETT: ...basically we got way overleveraged in the financial arena. And the American public got overleveraged too. We do need something to address that. We do need something to address institutions where the wrong incentives are in place so that their personal incentives are at real variance with what our national incentives should be. We need something to make sure we don't get into the situation again that we were in last September. And

⁴ In fact, we'll make a prediction now, based on current trends in credit and capital flows, that the next major financial crisis is likely to be centered in Asia, though there's no way of knowing when. It could take a decade, or two, or even three, especially considering the traditionally high level of savings in many Asian countries (South Korea being a notable exception).

leverage is a big key to it. Now that's a huge problem to attack and how it's written and how it's administered is not an easy job.

BECKY: Can you lay that down as a rule? Should it be that you can't be levered more than 10-to-1? You can't be leveraged up more than 20-to-1? How do you figure out?

BUFFETT: And it's very difficult. And you can't lay down a rule like that, unfortunately. Because just through derivatives you can have an enormous amount of leverage that doesn't show and you can have an interconnectedness that causes one domino to hit the next. It is not a simple problem. You don't just write down leverage of 10 or 20 to one or something of the sort. There's all kinds of different leverage. You can leverage against home mortgages with big down payments and that will be relatively safe. You can leverage against somebody else who's leveraged and you've got troubles getting compounded. So it's not a simple problem but it is an important problem.

BECKY: Is it one that can be tackled? Is there a solution, a potential solution?

BUFFETT: It's not easy. It's not easy. You need somebody - you need reasonable rules, and you need a very, very good administrator or group of administrators doing it. It's not an easy problem. People like to go to excesses. And the incentives are, in a market system, to overshoot. And it's happened over the years. America's genius has not been in avoiding problems, it's been in surmounting them once they happen. And fortunately, you know, we've come through again on that.

BECKY: So you're not saying it's an impossible task but it doesn't sound like you're very hopeful we can prevent something like this from happening again?

BUFFETT: I think that what started out with a tulip, maybe four-hundred years ago, and continued through the South Sea Bubble and all of those sorts of things, it's in human nature to go to excess. And it's very hard, in a country of 300-million people and a 14-trillion dollar GDP and all of that, to set up a set of rules that will prevent excesses in a market system. But I think there can be improvements made and I think that's what we're shooting for.

Our Bottom Line

We expect the topic of risk to remain prominent in multiple domains for some time. But we suspect that the cost of mandating health insurance is (very roughly) relatively fixed, and that conversations around it will be a matter of who bears the costs and realizes the benefits, and how. In the area of systemic financial leverage, we have no conviction that anything resembling sound, long term risk management strategies are in the works.

URLs:

<http://www.time.com/time/health/article/0,8599,1906105,00.html>

<http://www.insure.com/car-insurance/assigned-risk.html>

<http://www.symmetrycapital.net/idlespeculation/20090209.pdf>

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aHaggIeA0Zjk>

<http://online.wsj.com/article/SB124528385680425617.html>

<http://www.sedinc.com/good-reads.html>

<http://www.cnbc.com/id/31526815/page/2/>

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